QUARTERLY MARKET OVERVIEW – JANUARY 2017

"Trump, Farage, Renzi, Hofer…."

2016 was a year of surprises with events in the UK, US and Italy likely to shape our lives for many years to come.

At the same time, we could easily have added Austria; the significance of which shouldn't be underestimated. In the end the electorate overwhelmingly decided not to appoint its first fascist president since World War II; this may provide some indication as to how elections in France, Germany and Holland might eventually play out.

Taking a step back we entered 2016 with a sense of trepidation; the previous two years hadn't been great for risk assets and generally the mood wasn't that optimistic.

There were monetary concerns with China devaluing its currency. Weaker profits from the US stoking fears over a global recession. In the commodities sector, having had a torrid 2015 we saw oil prices continue to come under pressure which was not helped when sanctions with Iran were lifted. In the UK, there were no clear lines as to how the referendum would go which hurt sterling. Additionally, there was the Zika Virus spreading across Central and South America, which increased fears of this spreading across the globe.

It was not really shaping up to be a good year. Populism is a word which we are likely to hear more; the vote to leave the EU was a shock but looking back all the signs were there that it would happen (hindsight is fantastic), and once the results came through it seemed that nothing was impossible. The thought of Trump being President was real; Renzi offering a reformed political system seemed unlikely to succeed and there was a chance that Austria would elect a Fascist President.

When we look back it was building up to be a horror story!

As the year played out there were some bright spots; the Rio Olympics were relatively successful after the negative build up, and Dilma's ousting helped return optimism to the Country and the semblance of a somewhat stable government. In Europe Spain's Prime Minister Mariano Rajoy increased his share of the votes. So not everything was bad!

As events started to unfold there was an initial impact on markets but the timeframe to recover seemed to get shorter. The January crash took six weeks before a recovery came through, whereas the FTSE was at its highest point for the year only a week after the EU vote. In the US, the markets were down before the election, but since the election the S&P500 has continued to climb. And finally, in Italy the markets opened down after the referendum but were higher by the end of the same day!

Perhaps 2016 should be remembered as a year when the impact of political upheaval had little long term influence on markets. Despite an initial wobble, the markets just kept shrugging off bad news to post some of the strongest returns since 2009; the significance of this shouldn't be underestimated because over the last 7 plus years any slight whiff of uncertainty, marked a serious decline in market returns.

So, what can we take from 2016:

- If Leicester City Football Club can win the English Premier League, then anything can happen
- Opinion polls are often wrong
- Macro forecasts are often wrong too
- Global politics is shifting, and the establishment is in trouble
- The power of central banks is diminishing
- Structural change is needed, and rewarded
- Growth remains the key priority for China

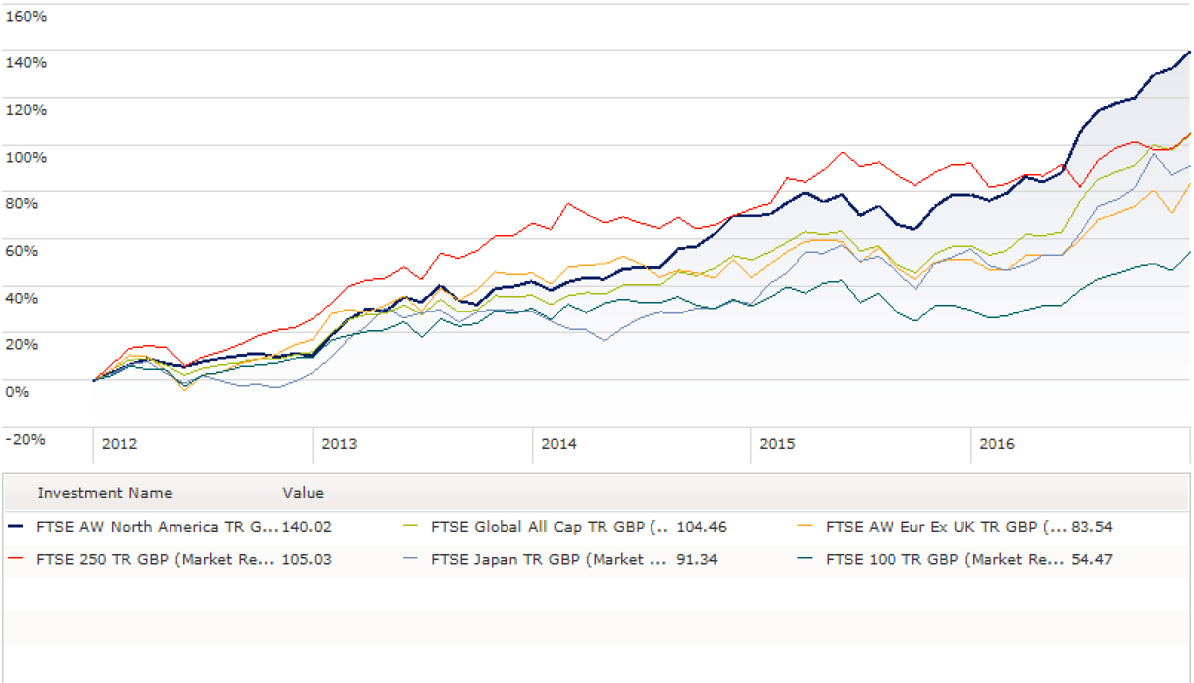
We understand that there is nervousness about the sudden exuberance within the markets but after over two years of relatively poor returns perhaps this has been a period of catch up. It is also worth adding that the FTSE 100, when factoring in inflation, has actually fallen in value over the last near 20 years, so is the index really that toppy?

We don't believe we will see the same returns in 2017 but as our report will show there are reasons to be pessimistically optimistic!

George Ladds
George Ladds, Director, January 2017

DEVELOPED MARKETS

Five year returns 1 January 2012 – 31 December 2016



Special note to graph: *You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced.*

Austerity seemed to be the only game in town…with the global economy settling for an environment of low growth, inflation and interest rates (certainly for the foreseeable future). Combined with this there were growing concerns that a recession was on the cards.

However, 2016 saw a seismic shift caused by political events. As a result, we are starting to see a real sea change with a rise in long term interest rates pushing bond yields up, the sense of faster growth and higher inflation; good news for equities, not so good for bonds.

The US seems to be the first leading economy to move away from austerity with interest rate rises expected during 2017, and inflation likely to exceed the 2% target. There is increasing evidence that the positive "vibe" is feeding out with the Global Manufacturing Index at its highest level for three years (this covers both developed and emerging markets).

There is a suggestion that interest rates in the UK could rise before the end of the year, but it is worth adding caution as 2017 is crunch time for the UK. Consumers will face higher inflation; meaning that the basic cost of goods like energy and food will go up. If companies ease back on investment and wage growth slows then we hit a potential problem particularly if consumers start tightening their belts. It is all very well to assume interest rates will rise in the UK, but if you factor in other issues it seems there is considerable risk associated with any move, and in fact the more likely outcome is a fall in rates.

The vote to leave the EU was a big shock to many but in all reality not surprising. I remember speaking to someone prior to the vote and they said it will come down to two things; economics and immigration. The pragmatic result would fall to economics because why take the risk with the unknown, but pragmatism had no part to play because it wasn't tangible. Immigration had a big impact because many feared the impact on their jobs and wages and that is real. Not everyone who voted leave, voted because of immigration but it played a massive part.

This movement against immigration will feed out into the elections in Holland, France, Germany and Italy and we should consider the potential for further political upset this year. Brexit in the UK remains a dark cloud circling over the economy. But, helped by the falling pound the UK has been remarkably robust however the answer to the question no-one knows is what will happen when/if Article 50 is triggered? Anyone who assumes that it won't be messy is we think sadly mistaken. On one side, Europe will not let a "problem child" go without making it look so horrible to deter others in following the same path; on the other May, has said she will walk away rather than take any deal.

Having said that, there is one thing that could play to the UKs favour. It seems that European countries do not want the EU to collapse, but if Italy voted to leave and perhaps France then there might be recognition that change needs to happen to keep the union together, and this could ultimately benefit the UK.

One final thought on the UK: it seems that sterling will take the strain for BREXIT negotiations, bad news will weaken it further but on the flip side it will rebound at the slightest piece of good news. The FTSE is at an all-time high and this is because many companies have overseas earnings and are therefore benefiting from the weak sterling. We ask ourselves if the FTSE can stay at this level; it wouldn't surprise us as there are elements of the FTSE that are still undervalued, plus in inflation terms the FTSE has actually gone down in value over nearly 20 years. Some believe that just on an inflationary adjusted basis the FTSE 100 level should be 11,000 plus.

In the US, whatever we feel about Trump he has appointed people who expect to get results and have done so in their professional careers. What is fascinating is that many don't have any political experience and it is this that is worrying some. Personally, governments made up of fewer career civil servants and politicians must be a good thing but only time will tell how this works in reality.

Trump has a target to 'make the US great again' and clearly, he will be focusing on that whatever form that takes in his mind! Lower taxes to enable companies to bring cash back will be good, and tax changes which make Americans feel they have more money will no doubt be a focus in the early days. A strengthening dollar is a worry for emerging markets but we think some economies will benefit from Trump's policies. Trump wants to focus on infrastructure and will need raw materials, the US will not have all the resources to deliver this and will need to turn to other countries for supply.

For the first time we have a social media president, a single tweet can write millions/billions from a share price, or even force us into assumptions around the direction of the government in terms of its global relations. Ultimately, he is a business man and we will see more of this. The markets are starting to feel optimistic about the US and how this might feed into the global economy, and with this there is a clear move away from austerity (now a dirty word).

Away from the US and UK and looking to Europe. Eyes are focused on politics with elections in Holland, Germany and France. There is likely to be an election in Italy towards the end of the year. There is a move towards more right-wing politics rather than extreme far right. There is a subtle difference and we think this showed through in Austria where there is simply not the appetite for extreme right wing leadership. Having said that nothing is certain, and there is a real chance that Le Pen could win in France. The markets seem almost numb to politics and it seems any shock will be short term.

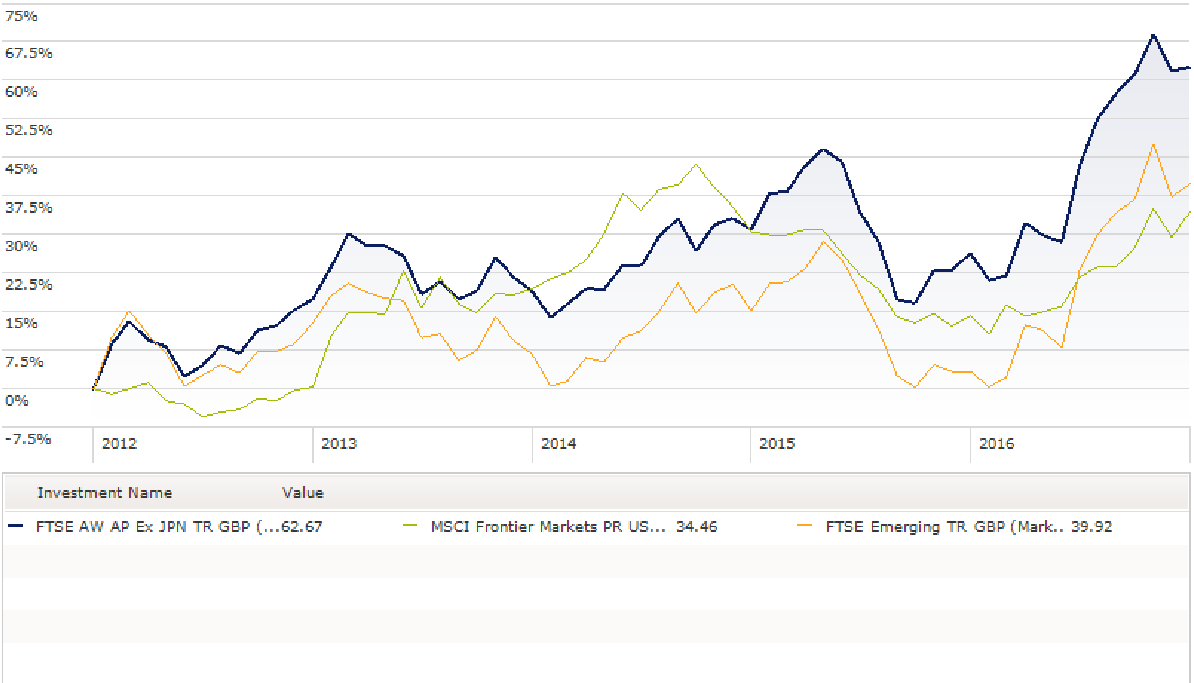
The Eurozone is continuing to improve and valuations remain attractive. The view is that this should continue throughout 2017 but the two main risks are the impact of unemployment and whether this ultimately slows any recovery, and any potential break up in the union. With the latter as we have indicated we don't think this is what EU members want, and they will do anything to hold it all together.

And finally, Japan…the economy did well with overseas visitors as well as benefiting from the lower oil prices. On the downside, negative interest rates lifted the value of the yen which hit corporate profits. Going into 2017 we expect Japan to tread water awaiting a combination of positive government budget packages and a resurgence in world growth helped by low oil prices, Chinese growth acceleration and the US pick up after Trump's win.

In conclusion, the focus is on the US and much of the exuberance within the markets reflects perhaps that austerity is coming to an end and there are other ways to kick start an economy. We shouldn't discount the impact of political upheaval but we don't feel there is an appetite for extreme far right leadership, maybe Thatcher-type leadership certainly in the UK and US. In the UK, the FTSE might feel high but once inflation is reflected it has actually fallen in value in the last 20 years and perhaps a figure around 11,000 is not extreme.

EMERGING, ASIA AND FRONTIER MARKETS

Five year returns 1 January 2012 – 31 December 2016



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The biggest concern without a doubt is a stronger dollar and a resurgent yet inwardly focused US. If there is a trade war with China it possibly won't hurt them as much as the regions around them.

If anything, there will be sparring between China and the US. China has a nuclear economic bomb it could trigger at any time. It holds 29% of all the US treasury bills, notes and bonds held by foreign countries. At any time, a calling in of all the debts would force the dollar to collapse and cause a crisis bigger than that in 2008. Of course, if they did this it would hurt them as well. The US will not want to trigger this hence the theory that it will be more sparring than anything that might tip China to pressing the button.

Although 2016 was good for emerging markets and Asia it has to be remembered that for the previous five years it had been a fairly miserable time. The view is that there are still attractive valuations and investors still have the potential to be rewarded. Clearly countries like Mexico face pressures from the US but countries like Russia and Brazil are on an improving trajectory.

It is also worth adding that there a number of economies that have debt to GDP below that of developed economies and higher interest rates meaning they have more flexibility over how they control their economies.

Although many economies have moved away from reliance on a single “product” (commodities and manufacturing) an upturn in oil prices has helped with the recovery in prices for iron ore, copper and even gold. This of course helps emerging markets.

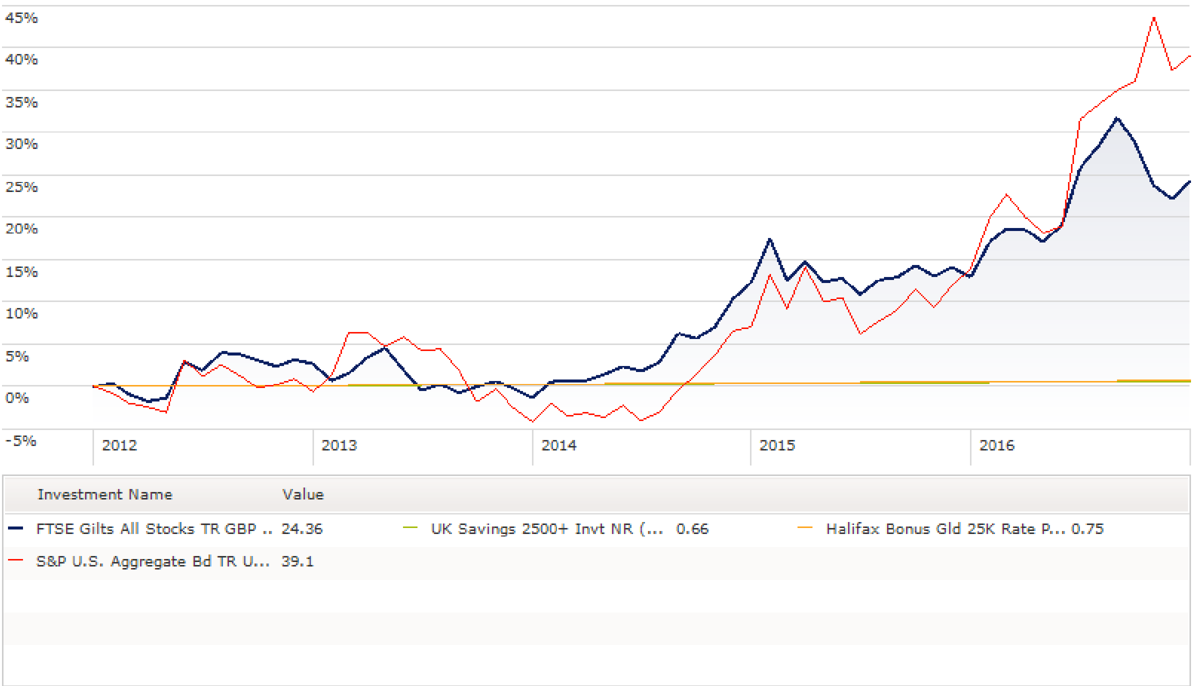
For manufacturing economies, we are seeing an uptick with many moving to a current account surplus. Turning to China there are signs of stability and GDP still remains a lot stronger than many other economies.

Going back to Trump although the focus is inward, infrastructure needs raw materials like steel and the US just doesn’t have the resources to be able to build everything it wants. Naturally it will turn to other countries to supply the materials meaning that not all countries will lose out if Trump makes good on his promise for infrastructure spend.

In conclusion, much of the future will focus on Trump and what he actually does! There will be posturing with China but they have the ultimate weapon, which could bring down the world’s markets and therefore there is likely to be more talk than action. Finally, we shouldn’t discount the fact that valuations remain cheap and many of the economies are in a better position than developed economies with plenty of financial levers at their disposal.

CASH

Five year returns 1 October 2011 – 30 September 2016



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There is much debate in the UK as to when rates will go up. My view in the last update is that it could be 5 or 10 years before rates go up. We are seeing rates rise in the US and we could see 3 or 4 rate moves this year. In the US rates going up doesn't directly impact households as many have 30 year fixed mortgages whereas this is different in the UK.

Although you want to control debt in the UK, it is actually keeping the recovery going because people are spending. With inflation rising people are going to feel less well-off and an increase in interest rates will reduce morale. This perhaps wouldn't be a problem in ordinary times but this is not one of those times. If/when we trigger Article 50 the UK faces a lot of uncertainty and although it is likely in the short term there will be benefits from a weaker sterling, any pullback from consumers will not be good.

The view is that perhaps we could see rates go back up to 0.50% because any impact would be minimal but beyond that we can't see rates going up until we have left the EU and even beyond that so we think 5 years before rates rise is not inconceivable but 10 years now seems less likely.

If interest rates remain low and with inflation now above 1% in real terms, cash is becoming a depreciating asset class. Going up the risk scale bonds might not be as attractive as they have been, because yields are going up and this is forcing down the price; therefore bonds may produce an income but the underlying asset value is likely to fall.

So, the challenge will remain as to how to achieve either an income or safety in a low interest rate environment with rising inflation. It is worth adding that this is not new and it is nearly ten years that cash savers have faced this dilemma, the question really is whether now is the time to do something about this.

In summary, very little has changed over the last ten years. We don’t see any evidence that rates will rise soon and in reality, cash will remain a depreciating asset in real terms for a few more years to come.

CONCLUSION

2016 was a year to remember for many reasons but it may also be a year that ended austerity and embraced a new period of growth within the global economy. Having leaders who are not career politicians might prove to be a good thing, and time will tell if this is the case.

There are some arguments that good active managers will benefit in this environment, and you can see this. Valuations for bond proxies like telecoms, utilities and consumer staples could be challenged as bond yields improve. And although there are some pointing to 20/25% jump in earnings for companies, some remain below their 2004/05 peak, which demonstrates there might be opportunities in the market; areas like energy, financials and healthcare remain attractive investments.

Despite all the political upheaval 2016 has been a good example of ignoring the political noise. Yes, these events will shape our lives for many years but they can’t defy investment fundamentals. Clearly the markets feel that a move away from austerity to something different is positive and the time to recover from political upsets seems to be shorter.

We know that many are uncomfortable with where the FTSE 100 and other markets are sitting but in some cases the inflation adjusted index is considerably below where it should be. 2016 was strong but it came about on the back of a weak 2014 and 2015 so in actual fact this is just catch up. We don’t think 2017 will deliver the same returns as 2016, but equally we shouldn’t rule out a positive year for investors.

Source: Charts have been sourced from Morningstar. Other data sourced from Schroders, Templeton, Hermes and JPMorgan. Any reference to a fund or share is not a recommendation to buy or sell that asset. Past performance is no guide to future performance and investments can fall as well as rise.